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THE PROVISION OF FINANCE FOR INDUSTRIES IN DEVELOPING COUNTRIES WITH A VIEW TO EXPANDING AND DIVERSIFYING THEIR EXPORTS OF MANUFACTURED AND SEMI-MANUFACTURED GOODS

Report by the UNCTAD secretariat

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*/ This report will be issued subsequently as a printed United Nations publication.

I. INTRODUCTION

1. Conference resolution 96 (IV) contains a set of interrelated and mutually supporting measures for the expansion and diversification of manufactured exports from developing countries. This resolution, inter alia, calls for effective measures for the improvement of the supply capability of the developing countries regarding the exports of their manufacturing industries. Among such measures the provision of adequate financial resources for the manufacturing industries to enable them to expand and diversify substantially their exports of manufactured and semi-manufactured goods requires intensified considerations.

2. The design and implementation of suitable measures aimed at facilitating the provision of increased finance on adequate terms for exporting manufacturing industries have to be considered both at the domestic level and with regard to external sources of finance. The issues involved are manifold and complex and are connected with broader issues in the areas of money, finance and industrial policy such as: the mobilization of domestic savings; the possibilities of generating industrial finance through the development of domestic capital markets; regional financial integration among groups of developing countries; the access of developing countries to foreign national and international capital markets; the provision of bilateral aid by developed countries for industrial development; and foreign investment policies.

3. The purpose of this report is to initiate, by discussing a few issues, a broad-based examination of the problems which developing countries face in providing the finance required by manufacturing industries for the expansion and diversification of exports. In further stages of its work the UNCTAD secretariat will examine the issues involved in greater detail.

II. THE FINANCING OF INDUSTRIAL EXPORTS

4. Manufacturers and exporters in the developing countries face a threefold competitive disadvantage vis-à-vis the export sector in developed market-economy countries with regard to obtaining finance in adequate measure and at reasonable cost. First, in the developed countries, the production and export of manufactured goods constitute an established sector of the economy which is able to offer the commercial banks an attractively large business volume. Secondly, the general level of money market interest rates in the developed countries is usually markedly lower than the interest rate level in the developing countries. Furthermore, major industrialized countries support out of public resources the provision of low-cost medium- and long-term export credit. Thirdly, the export sector in the developed market-economy countries has normally no difficulty in furnishing adequate bank collateral. In addition, their export trade in manufactures is, on account of its well established character, less risky than the non-traditional exports from the developing countries, whose exporters are establishing new business relations and venturing into new markets.

5. Accordingly, schemes for providing financial support for exports of manufactured and semi-manufactured goods from developing countries have to offer practicable solutions to three main issues involved: (i) assurance of easily available financing; (ii) competitive low-cost financing; (iii) insurance against foreign trade risks and assistance in providing bank collateral. The habitual way to achieve these objectives is the implementation of government-sponsored export financing and export credit insurance schemes.

6. The main methods applied to increase the availability and reduce the cost of finance for exports of manufactures and semi-manufactures are the operation of refinancing facilities for commercial banks with the central banks, government-sponsored export financing funds or specialized public financial institutions. The commercial banks are offered refinancing at concessional rates provided they do not charge the manufacturer-exporter more than a certain maximum interest rate which is fixed by the competent governmental authorities and somewhat higher than the preferential refinancing rate. In this way, the manufacturer-exporter obtains the finance at moderate interest rates enabling him to meet foreign competition.

7. Price competition by developed countries in export trade is particularly severe in the case of exports of capital goods which are sold on medium- and long-term credit of up to ten years or even longer at interest rates below market rates. The long maturities on these credits make manipulation of the interest rate a particularly effective instrument of price competition; a relatively small reduction in the interest rate can bring about a substantial reduction in the total sales price.

8. For developing countries, the promotion of their capital goods exports through officially supported preferential export credits poses a difficult predicament because the main buyer markets for the capital goods exports from the developing countries are again developing countries. On the one hand, the developing countries which export capital goods could ill afford a further softening of export credit terms to compete against the preferential credit conditions of the developed countries offering low interest rates, and long credit periods of up to ten years or more. On the other hand, it has to be taken into account that, as importers of capital goods, developing countries profit greatly from soft export credit conditions. The elaboration of a well-balanced solution which benefits the developing countries as both exporters and importers of capital goods constitutes a difficult undertaking.

9. It has been suggested that, if means could be found to enable developing countries exporting capital and other goods on credit to refinance the credit in private capital markets of developed countries, developing countries would be able to immediately realize the foreign exchange earnings. The importance of securing refinancing arrangements has been recognized by the Trade and Development Board which, at the first part of its fourteenth session, requested an examination of proposals including an export credit guarantee scheme to be sponsored by the international and regional financial institutions and regional development banks, as well as the question of refinancing of export credit with the aim of facilitating the expansion of exports from developing countries. 1/

10. An expert group accordingly convened by the Secretary-General of UNCTAD concluded that "it would be useful to establish a guarantee facility that would allow developing countries to refinance export credits directly in international financial markets on more favourable terms." 2/ Further examination of the

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1/ TD/B/528, para. 369.

2/ See report of the Expert Group on Export Credit as a Means of Promoting Exports from Developing Countries (TD/B/552), para. 43.

proposal at the technical level revealed that the establishment of such a facility as a separate international institution to guarantee medium- and long-term export credit paper issued by developing exporting countries was technically feasible and that there were no insuperable technical obstacles to its establishment.3/

11. The Committee on Invisibles and Financing related to Trade at the second part of its eighth session will give further consideration to this question.

12. The major problem of export-credit insurance schemes in the developing countries is the achievement of a cost-recovering operation at an early stage. The main factor which makes it difficult to accomplish self-sufficiency is the still comparatively small insurable export volume, in particular of manufactured and semi-manufactured goods, of many of their countries. Besides the problem of the economic viability of export credit insurance facilities, another difficulty faced by a number of schemes in developing countries is the shortage of trained professional staff.

13. To assist developing countries in establishing and operating export credit insurance schemes, developed market-economy countries may consider making available development assistance funds to export credit insurance institutions in developing countries to tide them over the financial difficulties during the initial phase of operation, until these institutions have reached self-sufficiency. Action may also be initiated on the establishment of export credit insurance facilities at regional or multinational levels. Such facilities would benefit in particular smaller developing countries where cost-recovering operations of national schemes probably cannot be effected for a long time to come so that the early establishment of a national facility would be incompatible with long-term cost-benefit considerations. Regional or multinational export credit insurance institutions could offer both direct insurance to exporters in developing countries without national schemes and re-insurance to existing national institutions. Consideration of the establishment of a regional scheme is currently being undertaken by governments in the ESCAP region.

III. FINANCE FOR INDUSTRIES FROM DEVELOPMENT FINANCE INSTITUTIONS IN DEVELOPING COUNTRIES

14. To ensure the availability of longer-term capital at reasonable cost, government-sponsored development finance institutions have been established in many developing countries. These institutions supplement the commercial banking sector, which mainly provides short-term working capital. Development finance institutions may specialize on a particular sector of the economy or may be multi-sector institutions providing financial resources for two or more economic areas such as agriculture, industry, infrastructure, and tourism. Institutions which concentrate their financing activities on industrial development have been set up in a number of developing countries. 4/

3/ See "An Export Credit Guarantee Facility: an examination of technical issues". (TD/B/655)

4/ For instance: Industrial Development Bank of India; Nigerian Industrial Development Bank; Pakistan Industrial Credit and Investment Corporation; Industrial Finance Corporation of Thailand; Industrial Development Bank of Kenya; Banque Ivorienne de Développement Industriel; Industrial Bank of Sudan; Malaysian Industrial Development Finance Berhad.

15. In the industrial sector, the promotional role of development finance institutions would consist in initiating and maintaining a viable process of industrialization geared to objectives and policy orientations which are consistent with the government's general development policy. Development finance institutions can provide manufacturing industries with various types of financing. The main service would normally be the provision of medium- and long-term loans. Other possible types of financing or of assistance in providing finance are guaranteeing the repayment of a loan made to the industrial entrepreneur by a third party such as a domestic or foreign commercial bank, the contribution of capital by investing in the equity of industrial corporations, the provision of underwriting services to help industrial enterprises raise finance from the investing public, and offering refinancing facilities to commercial banks which grant credit to the industrial sector. In the case of most developing countries, the financing needs of their manufacturing industries would not necessitate the provision of all the possible types of financing and financing services. The choice of the various types required to achieve the optimum promotional effect in the individual case can, however, be a difficult task.

16. As regards their financial resources, development finance institutions may attempt to attract capital from a variety of public and private sources, both domestically and from abroad. Among the domestic public sources, governments are the main suppliers of finance, normally in the form of equity and loan capital. Domestic private sources of finance can comprise commercial banks, insurance companies, business corporations and private individuals, investing in shares or bonds issued by the development finance institution. Foreign sources of capital for development finance institutions may be public sources such as governmental specialized financing institutions operated in developed countries to promote economic co-operation, 5/ regional development banks and the World Bank Group as well as private sources, such as foreign commercial banks and the foreign national and international capital markets.

17. Though the sources of finance of development finance institutions of developing countries differ over a broad range of possibilities, the financial resources which are actually mobilized from the various sources are in many cases not sufficient to provide these institutions on a consistent basis with the financial means required for a steady expansion and diversification of the industrial sector. As regards domestic sources of finance, many governments may find it difficult to substantially increase their financial contributions beyond the magnitude of means currently furnished. Future consideration may, therefore, in particular, bear upon suitable measures to enable development finance institutions to mobilize increased finance in the domestic capital markets.

5/ Among the governmental specialized institutions of developed countries providing finance, mainly in the form of loans on preferential terms, and, in some cases, as equity capital, are the "Kreditanstalt für Wiederaufbau" of the Federal Republic of Germany, the "Caisse Centrale de Coopération Economique" of France, the "Overseas Economic Co-operation Fund" of Japan, the "Commonwealth Development Corporation" of the United Kingdom, and the "Agency for International Development" as well as the "Export-Import Bank" of the United States.

18. Furthermore, capital may be furnished to an increased extent from external sources. The governmental specialized financing institutions operated in developed countries to promote economic co-operation, the World Bank Group, and regional development banks may examine their capacity to increase the financial resources which they have so far made available to development finance institutions in developing countries. In particular, the possibility of making available greater amounts of finance on concessional conditions may be explored.

IV. THE FINANCING OF SMALL-SCALE INDUSTRIES

19. In many developing countries, government-sponsored institutional arrangements have been implemented to facilitate the provision of finance for small-scale industrial firms. The variety of possible government-backed arrangements can be classified in six basic patterns: (i) a specialized small industry financing institution; (ii) small-scale industry "windows" in development finance institutions; (iii) a special fund administered by the central bank; (iv) joint financing arrangements between governmental financing agencies and the commercial banking sector; (v) refinancing facilities for commercial banks from an apex bank such as the central bank; (iv) credit guarantee programmes. The relative appropriateness of such alternative approaches necessarily varies from country to country.

20. Though detailed statistical operating results of the various schemes are not available, available information indicates that, with a few notable exceptions, most programmes have had only limited success in terms of substantially increased lending to small industrial entrepreneurs. The reasons are the lack of sufficient financial resources and administrative problems, in particular difficulties in covering the whole sector of small-scale enterprises. Currently, schemes reach only a fraction of the small industries. Effective measures are, therefore, required to strengthen the existing financing programmes and to implement schemes in countries which do not yet operate special arrangements but might consider them necessary to meet an existing need.

21. Special consideration may be given in developing countries to the implementation of hire-purchase schemes to promote the mechanization of small-scale industries. Under such schemes, the financing institution, instead of lending funds to small industrial firms for the acquisition of equipment, purchases the machinery required by the enterprises, and leases it to the entrepreneurs. As compared to the outright purchase of machines and equipment, the supply on a hire-purchase basis offers the advantage that the small entrepreneur is not required to furnish any security or surety, as is normally the case in respect of cash credit accommodation. As the concept of hire-purchase may still be an unfamiliar financing technique in many developing countries which furthermore involves complicated procedures, institutional aspects can post particular problems.

V. MOBILIZATION OF FINANCE FOR INDUSTRIES IN DEVELOPING COUNTRIES IN THE EURO-CURRENCY AND FOREIGN NATIONAL AND INTERNATIONAL BOND MARKETS

22. Consideration may be given to effective measures to improve the access of the developing countries and their industries to the Euro-currency markets and foreign national and international bond markets. Improved access to these markets would make it easier for developing countries to raise medium- and long-term finance for the development of the industrial sector and its capacity to export.

23. Though the aggregate figures of publicized medium- and long-term Euro-currency borrowings by developing countries in recent years are quite substantial, an analysis shows that the bulk of the borrowing is done by not more than about ten developing countries, among them, a few oil-exporting countries. Borrowing at long-term through bond issues by developing countries in foreign national and international capital markets has been very limited in the past. It seems that the difficulties that the majority of the developing countries and their industries have in raising funds in the Euro-currency market and external bond markets are basically due to the fact that the creditworthiness of many developing countries and their borrowing entities is regarded as insufficient by potential lenders and, furthermore, that most developing countries cannot afford the high cost of private market borrowing. In addition, the access of developing countries to the national bond markets of developed market-economy countries is limited by various regulatory and other constraints. Although the restrictions apply uniformly to all foreign borrowers, in practice developing countries tend to be at a disadvantage in a restricted market.

24. In most markets, the main constraint seems to be the official authority required for foreign issues and the existence of issue calendars or ceilings. Furthermore, in the majority of capital markets, de jure or de facto priorities for domestic issues are in operation. A constraint particularly detrimental to developing foreign bond issues can be legal restrictions placed on the proportion of foreign securities which institutional investors such as insurance companies, pension funds and savings banks may hold in their total portfolio.

25. The legitimacy of the demand of developing country borrowers for easier access to the Euro-currency and external bond markets has to be recognized. An examination seems, therefore, required with regard to possible support mechanisms for developing country borrowers who seek to raise finance in external capital markets.

26. Consideration may, inter alia be given to possibilities of rendering assistance through the operation of guarantee and interest subsidy facilities. The basic idea of guarantee and interest subsidy schemes as a means to facilitate the flow of funds from world capital markets to developing countries has been the subject of international discussion for a long time. 6/ Such consideration has in the past been concentrated on facilities to be operated at the multinational level. Some proposals envisaged that an international institution such as the World Bank would raise the funds in private capital markets under government guarantees and relend the funds to developing countries at low rates of interest subsidized out of an "interest equalization fund" 7/ The use of multilateral guarantee facilities has also been studied by a Working Group established in June 1975 by the Joint Development Committee of the World Bank and the International Monetary Fund.

6/ See: IBRD, The Horowitz Proposal, issued under cover of document TD/B/C.3/1 and Add.1 and 2; The Horowitz Proposal, Report of the group of experts, TD/B/C.3/23 and Corr. 1 and 2. The Horowitz Proposal: study by the UNCTAD secretariat, TD/7/Supp. 11; Multilateral interest equalization fund and related problems, report by the UNCTAD secretariat, TD/B/C.3/76; Financial mechanism for the future, report by the UNCTAD secretariat, TD/B/C.3/127.

7/ Such as the Horowitz proposal.

27. Future consideration may be directed to the implementation of multinational facilities and to guarantee and interest subsidy schemes to be operated at the national level in developed market-economy countries. Guarantee schemes at the national level could cover bonds issued by developing country borrowers in the domestic capital markets of developed market-economy countries. Suitable institutions for the administration of these schemes could be the government-sponsored agencies of developed countries currently providing guarantee cover for private investments in industries overseas, in particular in developing countries. Such investment guarantee schemes are in operation in the majority of the developed market economy countries. Apart from support mechanisms at the multinational or national levels, measures to eliminate the existing regulatory constraints on the access to external capital markets would be additionally required.

28. It has, of course, to be realized that the implementation of financing mechanisms proposed to facilitate the raising of finance in external capital markets by developing countries and their industries will require consistent efforts over a period of years in order to negotiate successfully the issues and problems posed by such schemes both at the political level and at the stage of practical realization.

VI. PROVISION OF INDUSTRIAL AND EXPORT FINANCE TO DEVELOPING COUNTRIES BY PUBLIC MULTINATIONAL DEVELOPMENT FINANCE INSTITUTIONS

(The World Bank Group and regional development banks)

29. To assist the developing countries in increasing substantially their share in world industrial output and trade, future consideration of effective measures to reach this objective may include an examination of possibilities of both expanding and improving the lending by public multinational development finance institutions for industries and industrial exports. As the legitimate demand from other important economic sectors such as agriculture, transportation, power and water supply, and education necessarily limit the financial resources which can be apportioned to industries by the multinational development finance institutions, an expansion of the lending to industry would require an augmentation of the total financial resources at the disposal of the institutions.

30. Consideration of an expanded role of multinational development finance institutions in providing finance for industries would also include the examination of possible improvements in the lending policies and the terms and conditions on which the financial assistance is granted. Thus, the financing of industrial programmes instead of the traditional project financing arrangements may be made a regular feature of the lending operations. Currently, loans are only granted for the financing of specific projects, leaving aside a few exceptional cases in which the World Bank has extended loans for the financing of programmes. Programme financing would leave the developing country borrower in control of the choice of project priorities, project design, technology, and source of procurement and would simplify and speed disbursements to developing countries.

31. Furthermore, the purposes for which industrial finance is provided may be expanded and could include finance for equity investment, as well as finance to meet local costs and working capital requirements. Except for the International Finance Corporation, which is flexible in the kinds of financing it provides and grants finance for these purposes, the other multinational development finance

institutions operate on a more limited scale. The loans made by them are mainly intended to cover foreign currency costs arising from the purchase of the goods and services necessary for the execution of a project. Working capital loans and equity finance are not furnished. In the case of some institutions which are currently limited to loan finance, the provision of equity finance would require an amendment of their basic articles. Other institutions would need only to activate provisions in their articles already enabling them to undertake equity investments.

32. The terms and conditions on which the multinational development finance institutions provide their lending may be reviewed with the objective of easing the financing burden for the developing country borrower and making it possible to tailor the lending more closely to the needs of the individual situation. Currently, the maturities and grace periods on loans for industrial projects tend to be relatively short. Future consideration may, in particular, include an examination of whether the grace periods currently granted on industrial loans are adequately adjusted to the gestation period of the industrial project financed. Another issue concerns the lending practice whereby, in the case of loans granted from ordinary capital resources, the major portion of the cost involved in the execution of the project normally has to be provided primarily by the borrower, whereas the development finance institution furnishes only a minority share. Consideration may be given in the context of future replenishments of their capital resources to rising the average financing share provided by multinational development finance institutions.

33. Furthermore, efforts may be made to increase the use and to improve the conditions of co-finance arrangements combining the resources of the multinational lending institutions with finance from the private banking sector as currently implemented by the Inter-American Development Bank, the World Bank and the Asian Development Bank. These arrangements can mobilize additional private financial resources for industrial development in developing countries. On account of the confidence which the multinational development finance institutions enjoy in the private banking sector, their involvement in the lending encourages the participation of private financial institutions and banking consortiums. The involvement of the public lending institutions can also facilitate the extension of commercial credits to developing countries and their industries on more favourable conditions than would otherwise apply.

34. On the other hand, it has to be noted that under co-finance arrangements linking commercial finance to development finance, the borrower may find himself losing the qualitative advantages of commercial borrowing, i.e. speed as well as flexibility which leaves him in control of the choice and implementation of the industrial project to be financed. Furthermore, the commercially funded loan and the loan from the multinational development finance institution are linked by a cross-default clause which provides that if one of the loans extended to the borrower is called into default, all loans in the financing arrangement including the one granted by the multinational institution would also be declared in default. The cross-default clause works on the assumption that a borrower will not, under any circumstances, default on loans granted by a multinational development finance institution. Thus, the objective is to secure the repayment of the commercial credit portion by stipulating sanctions rather than by providing effective guarantee mechanisms.

35. Regional development banks may consider the creation of special facilities within their institutions for the refinancing of export credits extended by exporters of manufactured and semi-manufactured goods in developing countries. 8/ As the granting of export credits entails the deferment of the receipt of the foreign exchange earnings, such financing facilities would be an adequate way of enabling developing countries to realize the foreign exchange earnings before due date by external refinancing.

36. As the bulk of manufactured exports from the developing countries still consists of manufactures and semi-manufactures habitually sold on short-term credit, it seems advisable not to confine export financing programmes to capital goods exports on medium- and long-term credit. Furthermore, facilities established in regional development finance institutions may be designed to benefit manufactured exports to all buyer countries, rather than limiting the export refinancing to intra-regional trade. On the other hand, some selectivity as to the types of exports covered by the schemes may be considered as a means to support exports of industrial goods in accordance with national export promotion priorities.

8/ See paragraphs 9 and 10 above.